

# ANALYSIS OF ORIGINAL AND AMENDED BILL

## Franchise Tax Board

Author: Klehs Analyst: John Pavalasky Bill Number: AB 1630  
Related Bills: \_\_\_\_\_ Telephone: 845-4335 Introduced Date: February 22, 2005  
Amended Date: March 29, 2005  
Attorney: Patrick Kusiak Sponsor: Franchise Tax Board

**SUBJECT:** Reporting Federal Income Tax Adjustments

### SUMMARY

This bill would clarify existing law that requires taxpayers to report federal income tax adjustments to the Franchise Tax Board (FTB).

### SUMMARY OF AMENDMENTS

The March 29, 2005, amendments correct drafting errors and more clearly identify the difference between "reporting a correction" and "filing an amended return." This is the department's first analysis of this bill and reflects the bill as amended March 29, 2005.

### PURPOSE OF THE BILL

The purpose of the bill is to preserve the current statute's requirement for taxpayers to report federal adjustments that become final after the normal four-year state statute of limitations (SOL) has expired.

### EFFECTIVE/OPERATIVE DATE

The bill specifically provides that the amendments are declaratory of existing law and would apply to any taxable year beginning before, on, or after the date the act takes effect.

### POSITION

Support.

On December 1, 2004, the Franchise Tax Board voted 2-0, with the representative from the Department of Finance abstaining, to sponsor the language included in this bill.

### ANALYSIS

#### STATE LAW

Current California law requires that if the amount of gross income or deductions reported on an individual's federal return filed with the IRS for any taxable year is changed, either by the taxpayer or the IRS, the taxpayer must notify the FTB of the change within six months of the "final federal determination" of that change, unless it does not increase the California income tax payable. The lynchpin of California tax administration in cases where the IRS audits a taxpayer is the provision that allows FTB an unlimited time to issue a proposed assessment increasing state tax on the basis of the final federal determination when the taxpayer fails to notify FTB of that change.

#### Board Position:

<u>  X  </u> S	<u>      </u> NA	<u>      </u> NP
<u>      </u> SA	<u>      </u> O	<u>      </u> NAR
<u>      </u> N	<u>      </u> OUA	<u>      </u> PENDING

#### Department Director

#### Date

Gerald H. Goldberg

4/12/05

A recent decision of the California Court of Appeal, *Ordlock v. FTB*, a case relating to the 1998 tax year, ruled that once the normal four-year SOL expires, the tax payable cannot be “increased.” The Ordlock court reasoned that there was no reporting requirement and so the extended SOL that comes into play where a taxpayer fails to report a federal adjustment did not apply<sup>1</sup>. The California Supreme Court has accepted the FTB’s appeal of this case and its impact could change based on that appeal.

### THIS BILL

This bill would amend Revenue and Taxation Code (R&TC) Section 18622(a) & (b) to provide that taxpayers must report federal adjustments that occur after the normal four-year SOL for mailing proposed assessments has expired. This bill would also amend R&TC Section 19057, relating to the normal four-year SOL to specifically cross-reference Sections 19059 and 19060, relating to the extended SOL for federal adjustments. Additionally, this bill would provide that the amendments are found and declared not to constitute a change in, but are declaratory of, existing law and would apply to any taxable year beginning before, on, or after the date the act takes effect.

### **OTHER STATES’ INFORMATION**

The states surveyed include *Florida, Illinois, Massachusetts, Michigan, Minnesota, and New York*. These states were selected due to their similarities to California’s economy, business entity types, and tax laws.

All of these states substantially conform to the federal tax base and follow federal rulings if not in conflict with state law. Florida’s conformity, however, applies only to corporations as that state has no personal income tax. Each of these states also require that the taxpayer report changes to the federal return by the IRS within a specified period of time, ranging from as few as 60 days to as long as one year, after the federal determination is final. In addition, all of the states surveyed have entered into reciprocity agreements with the IRS that make it possible to compare federal and state returns and to obtain notification of adjustments made to those returns.

### **FISCAL IMPACT**

This bill would not significantly impact the department’s costs.

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<sup>1</sup> The Ordlock court stated “because significance must be given to the statutory framework as a whole, section 19060 must be read in conjunction with section 18622. Under section 19060, subdivision (a), FTB may issue a notice of proposed deficiency assessment only when the taxpayer fails to report a change or correction by the IRS or fails to file an amended return “as required by Section 18622.” Because section 19060 incorporates the provisions of section 18622, the last sentence of section 18622, subdivision (a) is applicable. That sentence permits the taxpayer to apply the four-year statute of limitations in determining whether the federal changes increase the amount of tax payable. In short, Taxpayers need not have performed an idle act, namely, reporting to FTB the change or correction by the federal government when the statute of limitations barred FTB from assessing any tax deficiency. Because FTB’s 1998 notice of a proposed deficiency assessment was barred by the four-year statute of limitations, the trial court should have granted taxpayers’ motion for summary judgment on its complaint for a refund.” (*Ordlock v. FTB*)

## ECONOMIC IMPACT

### Revenue Estimate

The effect of this bill would be to reverse the Ordlock decision. As this bill would be declaratory of existing law, the proposal has no revenue effect. However, if this bill is not enacted and the California Supreme Court eventually upholds the Ordlock decision, income/franchise tax collections would be eroded. Based on audit data, if this bill was not enacted and the California Supreme Court were to eventually uphold the Ordlock decision, it would result in the following revenue losses under the Personal Income Tax (PIT) and Corporate Tax Law (CTL):

AB 1630 Not Enacted and Ordlock Decision Upheld [\$ In Millions]		
	Taxable Years	
	1999 and Before	2000 and After
PIT	-\$10.8	-\$10.0 annually
CTL		
Non-apportioning	-\$0.2	No Impact
Apportioning	Negligible Loss	No Impact
Total Tax	-\$11.0	-\$10 annually
Interest	-\$21.8	
<b>TOTAL</b>	-\$32.8	-\$10 annually
Negligible loss is less than \$150,000. For apportioning corporations, cases would be very limited as nearly all assessments are issued with the statute of limitations held open by a federal waiver.		

Note that the \$10 million annual revenue loss under the PIT for years 2000 and after is the net of foregone assessments totaling \$12 million and refunds of approximately \$2 million that the FTB could not refund to taxpayers due to the expired four-year SOL.

### Revenue Discussion

Estimates are based on an analysis of audit data and final federal determination data. Approximately 12% of PIT final federal determinations would meet Ordlock facts and circumstances (i.e., final federal determination received after the normal four-year SOL has expired).

## ARGUMENTS/POLICY CONCERNS

While for apportioning corporations nearly all assessments are issued based upon the SOL being held open by a federal waiver, this is not the case with respect to individuals. Based on an analysis of audit data and final federal determination data, approximately 12% of PIT final federal determinations would meet Ordlock facts and circumstances (i.e., final federal determination received after the normal four-year statute has expired).

If this proposal is not enacted and the California Supreme Court were to eventually uphold the Ordlock decision, then taxpayers that were audited by the IRS could fail to report the result to the FTB, hoping that the FTB would not be notified of the results by the IRS before the normal statute of limitations had expired (a form of “audit lottery”).

This change, declaratory of existing law, is necessary to preserve the current statute’s requirement for taxpayers to report federal adjustments that become final after the normal four-year SOL has expired.

## **LEGISLATIVE STAFF CONTACT**

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